



## **OXFORD ANALYTICA**

**CZECH REPUBLIC**

**FISCAL TRANSPARENCY**

**Country Report 2005**

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# CZECH REPUBLIC



## COMPLIANCE RATINGS

<i>Fiscal transparency</i>	2005	2004	2003	2002
Clarity of roles	●●●●	●●●●	●●●●	--
Availability of information	●●●●	●●●●	●●●●	--
Budget preparation	●●●●	●●●●	●●●●	--
Accountability	●●●●	●●●●	●●●●	--
<b>Score</b>	<b>4.00</b>	<b>4.00</b>	<b>4.00</b>	--

## OUTLOOK & COMMENTARY

The Czech Republic is likely to continue its progress towards the highest international standards in fiscal transparency. The key transition institutions have been scheduled for closure and the same approach will be applied to one extra-budgetary fund as well.

Ensuring full transparency will require attention to some methodological issues that have become more prominent of late. The discrepancies between the national accounting system and ESA95 have yielded significantly divergent results and allowed the authorities and commentators to choose results that better suit their purposes. At a minimum, greater attention should be paid to properly indicating and explaining the differences between them.

The ability of budgetary organisations to delay their spending until the following fiscal year must be carefully controlled. Also, macroeconomic and revenue projections should be better, and more continuously, coordinated. The political situation may make it difficult to properly address fiscal sustainability but some structural reforms are growing in urgency and should be launched after the 2006 elections.

## EXECUTIVE SUMMARY

### 4.00 Compliance in progress

Recent years have seen considerable progress in promoting better fiscal transparency standards in the Czech Republic. The regulatory framework governing the fiscal sphere has been comprehensively overhauled and now largely matches the best international standards. Czech EU accession has played an important role in accelerating and consolidating this process. Access to fiscal information, especially at the central government level, has become easy. Most agencies now operate websites that are well-designed, frequently updated, and comprehensive.

The adoption of the recent reforms will ensure considerable progress in the years to come, in as much as formal sunset legislation has been adopted for winding up most of the key transitional institutions, as well as an extra-budgetary fund. The National Property Fund, which has had primary responsibility for the privatisation process, will formally close its doors at the end of this year, although full incorporation in the Ministry of Finance (MoF) looks certain to be delayed by six months. The Czech Consolidation Agency, which has been in charge of bad loans, has been systematically divesting its assets and is likely to cease operating ahead of the original schedule, probably at the end of 2007.

In spite of the general progress and the formal commitment to further change, many feel that assessing the fiscal stance of the Czech Republic is more difficult than it is for the other countries of the region. This is largely due to significant discrepancies between the national cash-based accounting data and the ESA95-compliant figures. The situation has become especially marked this year with the significantly better-than-expected performance of the economy and its positive implications for government finances. Confusion has been created by the reluctance, or at least slowness, of the MoF to revise its economic projections and to ensure consistency between macroeconomic and revenue forecasts.

A recent revision to the Budget Rules has given budgetary organisations the option of delaying their expenditure past the current fiscal year. While it has undoubtedly increased the efficiency of government spending, it has also reduced transparency, since transfers to the budgetary reserve are treated differently by the two main accounting methodologies. Moreover, it has made it more difficult to predict the government's fiscal stance, because there is no *ex ante* information on the scale of such delayed spending. Nor do the delays have any impact on budget planning, since the government budget is based on the original budget rather than actual outcomes.

Important structural reforms, especially in the area of pensions, are being delayed because of the political sensitivity of the subject and the upcoming elections in 2006. Preparatory analytical work has been undertaken but it may have reduced the urgency of reform by revealing that minor modifications to the current system will ensure solvency for up to two decades. However, the demographic situation will deteriorate sharply thereafter and the ultimate costs of reform mount rapidly due to delays.

The Czech Republic's overall score is unchanged from last year.

## 1. CLARITY OF ROLES, RESPONSIBILITIES, AND OBJECTIVES



Compliance in progress

**The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed.**

### Structure, functions, and responsibilities of government

The 1992 Constitution of the Czech Republic and several laws clearly define the responsibilities of the government and set it apart from the private sector. The government consists of the central government in Prague, 13 regions and the capital city, as well as some 6,250 municipal administrations. The sub-national governments account for just over a quarter of the total general government budget.

The Czech public sector became highly institutionally fragmented in the late 1990s as a result of the creation of several extra-budgetary funds, although some of them have since been closed down. There are currently seven extra-budgetary or “state funds”: the State Environmental Fund, the State Fund for Support and Development of Czech Cinematography, the State Culture Fund, the State Fund for Soil Fertilisation, the State Transport Infrastructure Fund, the State Housing Development Fund, and the State Agricultural Intervention Fund. The most important of these are the Infrastructure Fund (*Státní fond dopravní infrastruktury*, which is actually growing in importance), the Housing Fund (*Státní fond rozvoje bydlení*), and the Agricultural Fund (*Státní zemědělský intervenční fond*) -- the operations of the others are quite small and the Fund for Soil Fertilisation is in fact due to be liquidated by January 2006. The Housing Fund has the potential to turn into a loss maker due to the importance of soft loans to young families and housing schemes. The total revenues of the extra-budgetary state funds is 55 billion korunas, or some 2% of GDP. In addition, there are separate agencies established to manage the sale and reform of state assets during the post-communist transition, most notably the National Property Fund (*Fond národního majetku*, NPF), the Czech Consolidation Agency (*Česká konsolidační agentura*, ČKA), and the Land Fund (*Pozemkový fond*).

### Coordination and management of budgetary activities

The *Act No. 218/2000 Coll., on Budgetary Rules* and related legislation govern the fiscal operations of the central government defined as the state budget and the seven state funds.<sup>1</sup> Specific laws exist for extra-budgetary funds. Local governments enjoy spending autonomy under the Constitution and the *Act on Municipalities*. However, they are dependent on the central government for the vast majority of their revenues. The central government, moreover, controls their indebtedness.

There are ongoing efforts to improve budget coordination at the central government level with the ultimate objective of fully merging the state extra-budgetary funds with the state budget. The conditions governing the activities of extra-budgetary funds are being harmonised with those of the state budget and their expenditures are included in the medium-term expenditure framework.<sup>2</sup> The budgets of the extra-budgetary funds are submitted to the parliament simultaneously with the state budget.

The budgetary rules have been revised to eliminate wasteful spending at the end of the fiscal year by permitting ministries to carry over their allocations from one financial year to the next. The problem with the new system, however, is that transfers to the Reserve Fund are classified as spending and thus show up as contributing to the

deficit under the national cash methodology, albeit not under ESA95, which can lead to significantly divergent measures of the fiscal stance. In addition, the use of this mechanism makes it more difficult to assess and forecast the fiscal stance of the government, since there is no *ex ante* reporting mechanism between the line ministries and the MoF of the expected transfers.

The fiscal responsibilities of the 14 regional governments created in 2001 have increased significantly as a result of the devolution of important spending items, notably education, health care, culture. However, while they will receive a greater share of total taxes from the central government, they enjoy only minimal independent tax-raising powers. In contrast, they can borrow money. Comparable provisions apply at the municipal level.

Effective fiscal management and control of sub-national fiscal activities is limited by the strict constitutional autonomy of the municipalities. Attempts to curb it in any area have almost invariably been referred to the Constitutional Court. For example, an attempt by the MoF to set national standards and ceilings in the regulations governing public-private partnerships was undermined by the municipalities. Two Czech municipalities have declared bankruptcy in recent years and, although the state initially refused to intervene, it ultimately did agree to help the municipalities. Overall, however, Czech municipalities accounts for only 4% of the overall indebtedness of the general government. The four largest cities account for three-quarters of this figure. Moreover, to date, the treat by the central government to limit transfers to local governments appears to have been effective in ensuring fiscal discipline. In addition, the central government is seeking to ensure control by promoting higher transparency standards through extensive requirements to publish fiscal information. The Public Finance Committee, an advisory body under the MoF, is involved in coordinating sub-national public finances.

The *Act No. 190/2004 Coll., on Bonds* requires MoF approval of municipal bond issues before an application is submitted to the Czech Securities Commission. In addition, a government resolution No. 346 of April 2004 on the Regulation of Municipal and Regional Indebtedness mandates the MoF to calculate debt service limit indicators on an annual basis. Under the resolution, debt-servicing costs cannot exceed 30% of the total tax and non-tax revenue of a sub-national government. In the event that the limit is exceeded, the MoF will demand an explanation and discuss a debt reduction plan with the government in question. However, there are no formal sanctions, although the level of government subsidies may be affected. Nor is there any mechanism for placing a sub-national government under central government administration. The risk remains, therefore, that sub-national governments will end up in a vicious circle of decreasing state subsidies and worsening indebtedness, which the state will in the end be forced to solve through a bailout operation. In 2003, 211 municipalities exceeded the 30% indebtedness limit.<sup>3</sup>

EU funds to the Czech Republic are remitted to the National Fund (NF) which is a section within the Ministry of Finance. The NF is solely responsible for handling the cash flows as the paying agency for structural and cohesion funds. In addition, it certifies the statutory compliance of the national system of implementation. The main agencies distributing EU funding are the Ministry of Regional Development (MRD), the Ministry of Labour and Social Affairs, and the Ministry of Agriculture. The NF and MRD collaborate closely on the preparation of the National Development Plan for the use of these funds. The MoF is responsible for the financial aspects of the plan, whereas monitoring is conducted by MRD. However, there is a recognised need for better integrating the receipts of EU funds and the system created for national co-financing. The reason for the decentralised management had to do with a desire to curb the power of the MoF which, however, has resulted in certain administrative complications.

### **Relations between government and public sector agencies**

The Czech National Bank (CNB) and the government have regular consultations on economic policy and the central bank performs some agency roles for the government, most notably in selling and managing government debt and in maintaining treasury accounts. Although the relationship is generally good, more could be done to clarify relations between the CNB and the government, for instance by means of a contractual service agreement.<sup>4</sup>

The National Property Fund is responsible for the technical implementation of the privatisation decisions concerning state-owned enterprises that are made by the MoF. In the process, NPF becomes the holder of the shares of companies to be privatised and is responsible for selling them. The income of the NPF does not form part of the state budget and its revenues are typically used to alleviate the environmental damage caused by privatised companies. However, they can also be used to finance other costs of the post-socialist transition. For example, with the sale of Český Telecom this year, most of the 70 billion korunas received is likely to be transferred to the extra-budgetary funds for transport infrastructure and housing.<sup>5</sup> The NPF is expected to close down by the end of 2005, although the completion of the process looks likely to be delayed by half a year, and it will be converted into an independent unit within the MoF. Its liabilities, which are currently projected at 95 billion Czech korunas, will likely be transferred to the Ministry of Finance or the Czech Consolidation Agency. A draft law envisages the closure of the Land Fund -- a smaller privatisation fund -- by the end of 2009. However, a lot of land remains in state hands and this target may well end up being revised.<sup>6</sup>

The Czech Consolidation Agency (ČKA) -- until 2001 the Consolidation Bank -- has served as a repository of bad loans during the economic transition. It operates under the *Act No. 239/2001 Coll., on the Czech Consolidation Agency*.<sup>7</sup> Following a major restructuring, it is currently pursuing a programme of publishing comprehensive information about its assets and selling them in preparation for closing down at the end of 2007, clearly ahead of the originally planned date of 2011. The ČKA subsidiaries are expected to terminate their operations in 2006. The state budget is to assume the ČKA's accumulated losses of some 63 billion korunas by means of a special bond issue in 2005-2007. ČKA can accept new impaired assets only until the end of 2005, when the NPF is closed down. All transactions in excess of 1 billion Czech korunas now require parliamentary approval.<sup>8</sup>

### **Government involvement in the private sector**

There are some instances where the differentiation between the government and the private sector remains blurred. The government guarantees the obligations of the Czech Consolidation Agency.<sup>9</sup> Only transfers from the state to cover ČKA losses are reported in the state budget. The activities of the Agricultural and Forestry Guarantee and Support Fund (*Podpůrný a garanční rolnický a lesnický fond*), a company fully owned by the Ministry of Agriculture, are covered by an implicit government guarantee.<sup>10</sup>

The government still holds equity in a number of enterprises through the National Property Fund for the purpose of preparing them for privatisation.<sup>11</sup> 2005 saw the completion of two of the largest remaining privatisations: the sale of a stake in the Unipetrol oil company to the Polish PK Orlen and the sale of Český Telecom to Telefonica of Spain. Even though the Czech government has, since the voucher privatisations of the 1990s, relied exclusively on sales to strategic investors as a way of divesting of SOEs, there is some potential for using public flotations as a way of stimulating the stock market. The energy generator ČEZ (České energetické závody) remains 67.6% owned by the NPF and is currently going through an ambitious restructuring programme that should make it an attractive candidate for further privatisation. Another likely privatisation candidate is the coal producer Severočeské doly. Other prospects include ČSA (Czech Airlines), the Czech Airport Authority (Česká správa letišť), and the ČEPS (Česká energetická přenosová soustava) electricity distributor. A less likely possibility would be the Post Office (Česká pošta), which still requires major restructuring.<sup>12</sup>

Some prices in the Czech Republic are still controlled, most importantly rents on existing contracts, drug prices, and transportation at the municipal level. Household contracts are the only remaining area of regulation in the energy market. The share of administered prices in the HICP basket is approximately 18%. There is no comprehensive plan for de-regulation.<sup>13</sup> The government is now planning to reduce the regulation of rents, albeit only very gradually, in part because the large differential between regulated and free-market rents is adversely affecting labour mobility.<sup>14</sup>

## **There should be a clear legal and administrative framework for fiscal management**

### **Legal framework for budgetary activities**

The *Act No. 218/2000 Coll., on Budgetary Rules* governs the central government's budgetary process. The law was amended in August 2004 through the adoption of binding medium-term (3-year) expenditure ceilings on the state budget and seven extra-budgetary funds.<sup>15</sup>

Regional and municipal authorities are subject to a different set of so-called "small budgetary rules." Spending by state funds -- most importantly the State Transport Infrastructure Fund and the State Housing Development Fund, -- are not governed by regular budgetary rules. Instead, particular laws passed in connection with their creation apply to their operations. Parliamentary approval is required for above-budget expenditures.

### **Legal framework for taxation**

All tax laws are published in the *Collection of Laws* and taxpayers receive ample assistance with their returns. The procedures governing tax collection are specified in the *Act No. 337/1992 Coll., on Administration and Collection of Taxes and Fees*. The customs procedures are covered by the *Customs Act No. 13/1993 Coll.*<sup>16</sup>

The Czech Tax Administration and the Customs Administration both operate under the auspices of the MoF and have their own informative websites, which publish tax codes, regulations, and calendars.<sup>17</sup> Tax collection is carried out by eight financial directorates and 222 financial offices, which are allowed to collect information about taxpayers and conduct investigations. Equal treatment of taxpayers is guaranteed by law and no substantial irregularities have been observed of late.<sup>18</sup> In practice, efficient tax administration is complicated by the complex legal regulations, which allow for an unusually large number of different types of exemptions. As an element of its medium-term fiscal reform plan the government is pursuing a reform of the tax system with a view to reducing the overall tax burden. At the same time, the Tax Administration is modernising its operations, partly with the assistance of foreign entities.<sup>19</sup> However, at this point, it is unlikely that the proposed tax reform measures will significantly address the inefficiencies of the system and especially the relatively high direct tax rates.<sup>20</sup>

### **Ethical standards for public servants**

A new *Public Service Act* was adopted in 2002 to define the status, rights, and duties of civil servants. The objective is to create a stable, depoliticised professional corps. Property disclosures are compulsory for all civil servants. The government has further approved a Code of Ethics for Public Administration Employees. The code addresses the issue of conflicts of interest and bans abuse of public authority.<sup>21</sup> A new *Act on Officials of Territorial Public Administration* seeks to accomplish the same tasks on the sub-national public level. The legislation conforms to West European standards and devotes considerable attention to the further education of government employees. Measures have been adopted to monitor public service and to assess its performance.

The Czech Republic joined the Council of Europe's GRECO (Group of States against Corruption) programme on anti-corruption conventions in 2002. The current legislation is deemed sufficient by the Czech government to combat corruption effectively.<sup>22</sup> However, although the Czech Republic has modernised its legislative framework to conform to EU standards, corruption remains a concern and is to a significant degree a generational problem entrenched during the communist and early transition years. The government's May 2003 report on anti-corruption activities concluded that corruption is still widespread and revealed little progress in combating it.<sup>23</sup> The Corruption Perceptions Index of *Transparency International* in 2005 ranked the Czech Republic as 47th of the 159 countries studied with a score of 4.3 (on a 10-point scale).<sup>24</sup> In particular, the prosecution of corruption cases remains often



ineffective due to limited resources. However, an ongoing judicial reform is expected to gradually improve the situation.<sup>25</sup> A new conflict of interest law has been under preparation for some time, but appears to have been relegated as a priority after the change of government this year.<sup>26</sup>

The Czech government introduced a governmental programme on combating corruption in 1999 and each ministry has drawn up its own anti-corruption programme. Since 2002, the requirement has been extended to all other state administrative bodies. Annual reports monitor the corruption situation and the implementation of the programme.<sup>27</sup> All ministries now have anti-corruption hotlines, although the contact information is not always easy find on the websites.<sup>28</sup> The efforts are coordinated by the Ministry of the Interior, which is also conducting public awareness campaigns on corruption, although some scepticism has been voiced about the adequacy of resources for the purpose.



## 2. PUBLIC AVAILABILITY OF INFORMATION



Compliance in progress

**The public should be provided with full information on the past, current, and projected fiscal activity of government.**

### Central government operations

The Ministry of Finance releases fiscal information on its website that exceeds the SDDS requirements. Government budget data are classified in accordance with economic, functional, and administrative criteria. The budget includes a policy statement and the underlying macroeconomic and fiscal assumptions. Standard budgetary data for the current and the two preceding years are complemented by data on intergovernmental grants, extra-budgetary revenues and expenditures, and transfers to local governments. The MoF also publishes data on state guarantees. The comprehensive budget document includes budgets prepared by the various ministries, broken down by agency.<sup>29</sup> Increasing attention is being paid to project budgeting, although information on individual projects is by no means comprehensive, with typically only the most important projects explicitly identified in the budget documents.<sup>30</sup>

The MoF publishes monthly data on the performance of the state budget, broken down into the principal revenue and expenditure categories.<sup>31</sup> Final accounts have to be published and presented for parliamentary approval within 4 months of the end of the budget year.<sup>32</sup>

### Public sector operations

The importance of spending outside of the state budget tends to reduce transparency, in spite of the fact that all public spending requires parliamentary approval, since the state budget is the main focus of attention.<sup>33</sup> The accounting rules applied to non-budget entities are different from the strict regulatory framework applied to the central government budget.<sup>34</sup> The government's medium-term fiscal programme includes a timeframe for liquidating some extra-budgetary funds.<sup>35</sup>

The state budget contains a projection for the local government sector, which in turn permits estimates of the general government position. In general, all entities receiving funding from the central budget are required to either produce their individual budgets (full funding) or show their position on a net basis (partial funding). Sub-national governments are required to use the same budgetary classification as the central government and they report to the Ministry of Finance on their fiscal activities on a monthly basis.

The requirement to produce annual convergence programmes up until euro-zone accession has improved the availability of data on the current and projected situation of the public sector as a whole. The reports are published on the MoF website.<sup>36</sup>

## **A commitment should be made to the timely publication of fiscal information.**

### **Debt reporting**

The Government Debt Management Unit (GDMU), an independent entity within the Ministry of Finance, is responsible for the issuance and management of debt in the Czech Republic. It issues reports on the current debt position. Comprehensive data on government debt, including its structure and maturities, is published on the MoF website which further publishes a debt issuance strategy and a schedule of auctions.<sup>37</sup> The quality of Czech debt management is widely recognised as having improved significantly in recent years. The GDMU has now been made responsible for managing the financial assets of the government and plans to publish comprehensive data on them. However, the current portfolio is only about 0.3% of the volume of outstanding government debt.

### **Advance release calendars**

The Czech Republic meets the IMF Special Data Dissemination Standard (SDDS) for the dissemination of advance release calendars. These are made public through the MoF and the IMF websites.<sup>38</sup> In addition, all data required by the European Union is submitted to Eurostat.

### 3. OPEN BUDGET PREPARATION, EXECUTION, AND REPORTING



Compliance in progress

#### Fiscal policy objectives, macroeconomic framework, and risks

##### Fiscal policy objectives

The official budget document contains a detailed policy statement with a projection of economic fundamentals and the main policy priorities. The projections are generally viewed as cautious. However, the process of arriving at budget totals and identifying spending priorities is still viewed by some analysts as opaque and inadequate. The budget totals appear to involve a rather mechanical adding up of approved requests from line ministries. The targets are not always clearly identified or are presented in an aggregate fashion.<sup>39</sup> Also, the so-called investment budget, which is based on programme budgeting, appears to serve more as a means of formulation than actual budget management.

The amended Act on Budgetary Rules has introduced a three-year fiscal targeting framework starting with the 2005 Budget. Unlike the previous medium-term projections, the new targets are meant to be binding. All the seven state extra-budgetary funds are included in this framework. The only circumstances under which the expenditure ceilings can be modified include a parliamentary vote and certain types of legislative changes. Some extra-budgetary funds can exceed their annual expenditure ceilings by re-allocating or postponing spending.<sup>40</sup> This year, the Czech Republic has been experiencing an unexpectedly favourable macroeconomic environment and the ceilings in place have proven much more restrictive than intended. However, it is less clear to what extent the new system is sufficient to improve the fiscal situation over the medium to long term, given the magnitude of the fiscal and demographic challenges facing the country.<sup>41</sup>

A key objective of the government's programme of fiscal consolidation is to bring the public sector deficit down to levels compatible with the Maastricht criteria and the legal obligation to adopt the euro as the national currency. In compliance with EU requirements for non-euro-zone members, the Czech Republic publishes an annual convergence programme, the first one of which was released in May 2004. It is likely that the requirement to produce such programmes will further promote a culture of medium-term planning. The convergence programme includes a section outlining the goal and priorities of government policy.<sup>42</sup> However, effective fiscal consolidation will likely depend on a successful reform of the pension, sickness insurance, and related systems, given the dominance of mandatory expenditures. A pension reform draft is currently under discussion but is unlikely to be implemented before 2006-7. The sickness insurance system looks likely to be overhauled as of 2006.<sup>43</sup>

##### Macroeconomic framework

The MoF has a macroeconomic forecasting division, which produces and publishes quarterly forecasts. The modelling framework, which is constantly under development, is not publicly known, but the models play only an auxiliary role in formulating projections. The forecast horizon has been extended to four years in line with EU requirements.<sup>44</sup> While all forecasts are prepared internally, the ministry does hold a semi-annual colloquium bringing together experts from universities and the private and public sectors for the purpose of comparing assessments of the macroeconomic framework.<sup>45</sup> The quality of the forecasts prepared by the Ministry is deemed to be high and the conclusions are seldom contested, even if the Ministry often seems to err on the side of caution. However, the accuracy of forecasting fiscal flows has deteriorated of late in the face of the unexpectedly strong

macroeconomic performance of the Czech Republic. Many analysts feel that there is no obvious connection between the government's macroeconomic forecasts and projections of tax revenues, partly because the macroeconomic forecasting division of the MoF is not seen to play a sufficient role in budget planning. The actual government receipts have been above the government's projections by the equivalent of some 2% of GDP. This problem is likely to become amplified, since budget preparation is based on the original budget plans, rather than the actual outcome.

The full text of the MoF's economic projections, as well as an archive of forecasts starting in 2001, is available on the MoF website.

### **Fiscal risks**

The two main sources of fiscal risk are (i) state guarantees from government support of development projects and annual subsidies for them, and (ii) bad assets in public sector institutions as a result of directed credits and purchases of low quality assets. However, a great deal has been done in recent years to consolidate the sector, most notably through the establishment and incorporation into the government sector of the Czech Consolidation Agency in 2001.<sup>46</sup> The government, starting in 2003, has re-classified some guarantees as "high risk" and included them, going back to 1994, in general government expenditure for the years in which they were first exercised. Given the magnitude of such guarantees, especially ones issued in connection with the banking sector restructuring of the late 1990s, the government debt and deficit increased by 185 billion Czech korunas, or 7.3% of GDP, in 2003.<sup>47</sup>

The use of the government guarantees has become extremely restrictive since 2001 under the *Act on Budgetary Rules*, which stipulates that each guarantee requires both government and parliamentary approval. Although only five guarantees were issued in 2001-3, 2003 saw the passage of an open guarantee to the newly established Railway Transport Infrastructure Administration (*Správa železniční dopravní cesty, SŽDC*). However, the government places annual limits on guaranteed borrowing by SŽDC. Loans for the modernisation of railway lines are not guaranteed, unless otherwise stipulated by law.<sup>48</sup>

The *Act on Budgetary Rules* further requires an annual comprehensive statement on guarantees, which is used in the preparation of the state budget. The statement assesses the likely cash impact of the existing guarantees in the medium term. The Budget Act for a given year now catalogues all guarantees with an assessment of the probabilities of them being called. A guarantee fund to cover the sum thus arrived at will be set up as of 2005. The State Budget Final Accounts offer an account of guarantees extended during the preceding year and all calls on existing guarantees.<sup>49</sup> In spite of considerable progress, there is currently no universally accepted measure of fiscal risks in the Czech Republic. The European Commission estimates the contingent liabilities arising from state guarantees at some 12.2% of GDP.<sup>50</sup> The growing use of public-private partnerships – some 20 projects at present – may create a new source of contingent liabilities.

The three-year budgetary outlook provides two different economic scenarios -- active and passive, depending on the pace of fiscal reform -- and discusses their implications for state finances. In addition, the Convergence Programme, in connection with macroeconomic sensitivity analysis, outlines a medium-term optimistic and pessimistic scenario.<sup>51</sup> The government further provides long-term estimates of the fiscal risks associated with the ageing population and an inter-departmental working group has produced estimates of the fiscal impact of pension reform according to five different proposals of the parliamentary parties, as well as benchmark scenarios of no change and only parametric change. It is less obvious, however, that this effort has sufficiently inculcated a sense of urgency among the political establishment or the general public. Among other things, the Pension Reform Group found that it will be relatively easy to balance the current pension system for 20-40 and even no reform would permit solvency for another 10-15 year. Thereafter, however, the situation will begin to deteriorate very rapidly. As a result, the greater delay in launching serious reform, the higher its ultimate cost.<sup>52</sup> Reform of the pension system to date has been purely parametric. For example, the government has agreed to increase the retirement age from 63 to 65 but only as of 2012. In addition, tax breaks have been introduced for voluntary pension schemes. The government is

now also analysing the fiscal implications of the situation in the health care sector and in education. For example, health insurance agencies are facing increasing financial difficulties because of growth in the salaries of physicians.

The government's room for manoeuvre is further restricted by the increased fiscal competition in the region and beyond where tax reductions are used as a way of attracting increased foreign investment. The Czech Republic currently has some of the highest revenue and expenditure ratios in the region and the pressure to reduce them is likely to remain strong in the coming years.<sup>53</sup>

Fiscal risks arising from exchange rate fluctuations are minimal because of the insignificant level of foreign debt, although the government launched a programme of euro-bond issues in July 2004. Hedging is used to manage the risks associated with the issues. More generally, the government has been reducing refinancing risks, systematically increasing the average maturity of state debt since 2000. The target is to have more than 50% of government debt in long-term maturities.<sup>54</sup>

Risks associated with defaults by sub-national governments have been brought under control with the passage of improved controls of local and regional government borrowing and indebtedness. The 2002 amendment to the *Act on Municipalities* and the *Act of Regions*, which significantly increased the fiscal responsibilities of sub-national governments, sought to avoid moral hazard-type problems by explicitly denying government responsibility for their debts. In spite of this, the government in 2003-2004 transferred a total of 3.5 billion Czech korunas to the regions in order to cover the arrears of hospitals.<sup>55</sup>

### **Fiscal sustainability**

There are no formal calculations of fiscal sustainability, although some explicit discussion on the subject is included in the *Convergence Programme*.<sup>56</sup> However, budget decisions have come to be increasingly placed in a medium-term framework, even if the effectiveness of this has been tested by the government's small parliamentary majority. Although the recent deterioration of the fiscal situation has been arrested, the source of the improvement has been cyclical rather than structural.<sup>57</sup>

The budgetary rules seek to promote fiscal sustainability by minimising the ability of individual budgetary organisations to modify their spending plans. They currently have no discretion on their spending to the extent that it has an impact on the overall budget balance. Transfers between individual chapters are typically allowed subject to a 5% ceiling.<sup>58</sup>

The Act on Budgetary Rules requires the inclusion of medium-term forecasts of the most important revenue and expenditure categories in the annual budget. The MoF now prepares 10-year fiscal forecasts and *ad hoc* long-term strategy studies have been undertaken in particular areas. The MoF calculates structural and cyclical balances and measures of fiscal sustainability. Such forecasts are especially important in connection with the Czech strategy for euro-zone accession. Under the budgetary rules, revenues in excess of expectations cannot be used to fund current expenditures.<sup>59</sup>

Under its convergence programme, the government is committed to joining the euro-zone in 2009-2010. However, the strategy relies very heavily on meeting the minimum deficit criteria rather than targeting a fiscal balance. This, therefore, raises the prospect of the Czech Republic narrowly qualifying for the adoption of the euro and being forced to continue fiscal austerity without monetary autonomy.

Public sector debt is expected to keep growing as a proportion of GDP, reaching 39.4% by the end of 2006. However, fiscal consolidation, if successful, should begin to reduce the share thereafter.<sup>60</sup>

## Budget presentation

### Data reporting

The MoF prepares a quarterly report on the central government's budget implementation. The government is further obligated to submit biannual reports to the parliament. These documents describe recent fiscal developments and assess the outlook for the rest of the year in light of ongoing economic trends.

There has been a considerable improvement in data quality over the past decade. The available government data, while still imperfect, is deemed adequate for modelling and forecasting purposes. The lags between initial estimates and final statistics now fully meet the Eurostat norms.<sup>61</sup> The Czech Republic is a member of GDDS and SDDS and international standards are consequently used in the compilation and publication of statistical information.<sup>62</sup>

Data provided by local governments is good and uses the same budgetary classification as the central government. Sub-national governments are required to report on their fiscal position to the Ministry of Finance on a monthly basis. However, the information is not made publicly available.<sup>63</sup>

The government provides no data on tax expenditures, which are quite extensive, especially in the case of the personal income tax. The Ministry of Finance is preparing a case study estimating tax expenditures caused by social support programmes.<sup>64</sup>

The coverage of the ESA95-compliant data submitted to Eurostat is broader than the MoF's own data on the general government. The most recent additions include the subsidiaries of the Czech Consolidation Agency, the Railway Infrastructure Administration, and the Viticulture Fund.

## Budget execution and monitoring

The Ministry of Finance prepares a monthly report on the execution of the state budget. The data is highly aggregated, covering the main income and expenditure categories. Some commentary is provided. Consolidated general government data is published on a quarterly basis.<sup>65</sup> However, the information is widely criticised as difficult to verify.<sup>66</sup> The government intends to include chapters on implementation by individual agencies in future final reports. To date, there have been no systematic attempts to measure the efficiency of fiscal activity.<sup>67</sup>

The Ministry of Finance has a Division of Internal Audit and a Central Harmonising Unit for Financial Control, which is responsible for developing concepts of financial control and ensuring harmonisation with EU regulations. Internal audit is governed by the *Act No. 320/2001 Coll., on Financial Control in the Public Sphere and Changes to Certain Acts (Act on Financial Control)* and the MoF decree No. 416 of 2004. The purpose of the legislation, which broadly complies with international best practices, is to ensure the economic, efficient, and compliant use of public resources.<sup>68</sup> In compliance with legal requirements, the Ministry produces annual reports on the results of internal control which are published on the website.

### Accounting basis

The MoF uses a national budgetary classification that is similar to the GFS standard and reports cash data. GFS methodology is applied to general government expenditures and revenues. The government presently applies the cash-based GFS1986 standard exclusively, but is currently proposing to introduce partial accrual accounting with a view to eventually adopting the fully accrual-based and ESA-compliant GFS2001 system.<sup>69</sup>

ESA95 compliant accrual based fiscal statistics are compiled and reported by the Czech Statistical Office in accordance with EU requirements.<sup>70</sup> In the recent past, accounting based on the national cash methodology and the ESA-compliant fiscal data submitted to Eurostat have resulted in increasingly divergent representations of the fiscal situation. The ESA figures have painted a dramatically more favourable picture of Czech government finances, in part because the transfers to reserve funds are calculated as temporary and thus not part of the deficit. This has been both confusing and a source of inconsistency as the authorities and commentators have been able to choose the data that best suits their purposes in particular situations. In general, it has made it more difficult to estimate the fiscal stance of the Czech government.

### **Procurement and employment**

The public procurement law – *Act No. 40/2004 Coll., on Public Procurement* – was passed last year in order to ensure EU compliance. Under the new law, EU rules ordinarily apply for construction works and supply and service contracts worth more than 2 million Czech korunas (some 62,000 euros). However, the exact scope of the application of EU rules is difficult to determine. In addition, the time frames are currently shorter than under EU rules and negotiated procedures can be used more widely. All tenders are published in an information system administered by the Ministry for Regional Development.<sup>71</sup>

Corruption in the area of procurement has been endemic, as revealed by a recent Supreme Audit Office audit. Independent studies have suggested the possibility that most public sector projects have not fully met legal norms. The latest government report on corruption still identified numerous defects in law and public procurement practices. However, the situation is generally felt to be much better at the national level than in the localities.<sup>72</sup> Facilitation payments remain common and the judicial system is often incapable of effectively combating these problems. Filing a complaint is a costly and cumbersome process, since it typically requires a monetary deposit with the Anti-Monopoly Office (*Úřad pro ochranu hospodářské soutěže*). It is likely that de-regulation of the permit system would reduce the scope for corruption and lobbying.<sup>73</sup>

The government is bound by all private sector labour laws and there is good understanding of the rules governing pay, hiring, and firing.<sup>74</sup>

### **Fiscal reporting**

The Ministry of Finance publishes monthly data on the execution of the state budget. Data on the extra-budgetary funds is available on a quarterly basis. Sub-national entities report to the MoF on a monthly basis, but information from the internal database is not made public. The state final accounts are currently prepared within 4 months of the end of the fiscal year. They are approved by the parliament.<sup>75</sup> The relatively high degree of autonomy of local government complicates the task of monitoring general government finances. However, measures towards consolidating the reporting of fiscal activities are being taken.<sup>76</sup>



## 4. ACCOUNTABILITY AND ASSURANCES OF INTEGRITY



Compliance in progress

### Data quality standards

As a subscriber to the IMF SDDS, the Czech Republic meets the standards for the timeliness and quality of fiscal data.<sup>77</sup>

There is constant internal control of budget execution and regular availability of detailed data. The comprehensive Final Accounts of the government include a formal reconciliation with central bank accounts. The Supreme Audit Office audits the government accounts on an ad hoc basis and reports to the parliament and the cabinet. Most observers rate the quality of Czech fiscal data highly.<sup>78</sup>

The transparency of fiscal data will increase when the government completes the ongoing transition from the cash-based GFS86 standard to GFS2001, which largely matches the ESA95 standards. Some progress in this area has already been made. GFSM2001-based figures have been converted from GFS 1986 cash-based sub-aggregates. Elsewhere, the government will follow transformation tables, which will permit mixed cash-accrual reporting. Ultimately, however, only the completing of this process will permit full transparency and consistency between central government and general government statistics.<sup>79</sup>

### Independent scrutiny of fiscal information

#### Independent Audit

The Supreme Audit Office (*Nejvyšší kontrolní úřad*, NKÚ), which consists of six central and eight regional departments, is an independent organisation with a constitutionally enshrined status.<sup>80</sup> It audits government revenues and expenditures, state property and funds, and the performance of various budgetary programmes on the basis of selective annual programmes. There is no annual financial audit of all organisations, although the legal basis for it exists. NKÚ further comments on an ad hoc basis on government budget reports, draft regulations, government programmes, and the performance of ministries and agencies. NKÚ's audit still consists very heavily of *ex post* compliance control with an exclusive focus on budget execution. However, the use of performance audits is increasing and the organisation intends to move towards more financial auditing. NKÚ reports are submitted to the parliament, the government, and the CNB, and reproduced in the quarterly *NKÚ Bulletin*. Given the constitutional autonomy of sub-national authorities, NKÚ can only audit their use of state subsidies, although these do account for the vast majority of their revenues.<sup>81</sup>

The NKÚ carries out its work in line with international standards and with a high level of professionalism. Its role is defined in the Constitution and it is fully independent in its operations. NKÚ meets the standards of the Lima Declaration of INTOSAI. NKÚ's head and his deputy are nominated by the parliament and appointed by the president. The operations of the Office, especially in terms of strategic planning, were adversely affected by a delay of over two years in appointing the president of the NKÚ, a situation which was only resolved in November 2005. Similarly, some criticism has been voiced of an occasional tendency to focus on matters of secondary importance.<sup>82</sup>

Somewhat problematically, no institutional mechanism exists to follow up NKÚ's recommendations, although all findings are discussed in government. NKÚ usually repeats its audit after two years, resources permitting. The NKÚ produces a published quarterly report in addition to its annual report.<sup>83</sup>

The Social Security and Health Funds have their own audit procedures based on their founding laws.<sup>84</sup>

Municipal and regional governments must have their accounts audited on an annual basis according to MoF instructions. All regional governments are audited by private auditing firms. Most municipalities are audited by private companies, but those with populations below 5,000 have the option of an audit free of charge by respective regional governments. Both financial and compliance audits are performed. Any irregularities have to be removed in accordance with the *Accounting Act*. Fairly substantial fines are imposed in the event of non-compliance.<sup>85</sup>

Under the new *Act No. 420/2004 Coll., on the Examination of Financial Management of Self-Governing Territorial Units and Voluntary Unions of Municipalities*, regions will be audited by the Ministry of Finance. Municipalities will be able to choose between a free audit by the regions or an external audit at their own expense. Municipalities availing themselves of bank credit – some 200 in total – must have their accounts audited by independent auditors. All audit reports are submitted to the Department of Financial Control of the MoF, which devotes particular attention to highly indebted municipalities and governments receiving EU or other external funding.<sup>86</sup>

The Czech Republic has adopted the EU norms on public internal financial control. However, some of the implementing legislation still remains to be passed. Moreover, the quality and quantity of staff at internal audit units often needs improvement.<sup>87</sup> Following the necessary reforms, the NKÚ hopes to move towards a more comprehensive system of auditing the entire public sector, as opposed to merely the state. The NKÚ advocates a universal system of internal audits, which would supply the basic information needed to meet the target.

### **National Statistics Agency**

The Czech Statistical Office is legally required to collect data and produce statistical information on social, economic, and environmental developments in the Czech Republic. The independence of the CSO is enshrined in law and its head is appointed by the president of the Republic. All ministries are included in the Programme of Statistical Surveys by the CSO. They are required to provide the Office with all necessary data in a timely manner and free of charge. The CSO makes the results of its surveys available to the public through its own publications and the mass media.

The quality of the data collected by the CSO is generally high and most statistics are provided within standard lags. However, the resources of the Office are stretched and some areas of activity have been adversely affected by recent budget cuts. CSO currently provides preliminary data on the main aggregates with a lag of three to eight months. Detailed expenditure and revenue data is reported with a lag of 12 months.<sup>88</sup>

Virtually all fiscal data for the general government is provided to the CSO by the MoF. Data from budgetary organisations, the seven state funds, regions, and municipalities is cash-based. The MoF data is accrual-based and includes accrual-based balances for budgetary organisations. The Ministry of Health and the Ministry of Labour and Social Affairs report monthly cash data on social security contributions. Social security funds and public universities report directly to the CSO. Data from the social security funds is collected by means of a quarterly statistical questionnaire since they use an accounting system which is not fully compatible with the national accounts methodology. Statistical questionnaires are also used with some other central and local government units on an annual basis in order to ensure ESA95 compliance.

CSO is the national reporting agency for Eurostat and is responsible for converting national fiscal statistics into a ESA95-compliant format.

## INTERVIEWS

Representatives of *Oxford Analytica* interviewed the following individuals during a visit to the Czech Republic between 17 and 21 October 2005:

### Ministry of Finance

#### 19 October 2005

Drahomíra Vašková	Deputy Director	Department of Financial Policy
František Cvengroš	Head	Section of Macroeconomic Forecasting
Zuzana Šmídová		Department of Fiscal Policy
Tomáš Kadrmas		National Fund

#### 21 October 2005

Jiří Franta	Head	Government Debt Management Unit
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### Czech National Bank

#### 20 October 2005

Ivan Matalík	Director	Fiscal and Structural Analysis Division
Jan Filáček		Monetary Policy Division

## ADDITIONAL INTERVIEWS

#### 18 October 2005

Miroslav Leixner	Chief Director, Audit Section	Supreme Audit Office ( <i>Nejvyšší kontrolní úřad</i> )
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#### 20 November 2005

Ludmila Vebrová	Head, Government and Financial Accounts Section	Czech Statistical Office ( <i>Český statistický úřad</i> )
Viktor Kotlán	Head of Research	Česká Spořitelna
Pavel Sobíšek	Chief Economist	HVB Bank
Václav Verner	Economist	HVB Bank

#### 21 October 2005

Marek Petruš	Correspondent	Reuters
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## NOTES

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